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Discussion of substantive issues related to international cooperation in tax matters: definition of permanent establishment: proposed revised article 5 commentary

Proposed new Commentary on Article 5: paragraphs 1 to 15.13

Note by the Working Group on Definition of Permanent Establishment**

I. Introduction

1. At the fifth session of the Committee of Experts on International Cooperation in Tax Matters, held in Geneva from 19 to 23 October 2009, a number of working groups were convened in cases where an issue had already been dealt with and approved by the Committee, but where further work was required.

2. The Working Group on Definition of Permanent Establishment is mandated to:[1]

> finalize the current work on the definition of permanent establishment, involving work related to finalizing the Commentary on Article 5 including revising the Commentary for greater coherence with Article 14 (for those who wish to retain that Article). It was recognized that, in the longer term, revisions to the Commentary on Article 5 might be required to maximize coherence and consistency with Article 14, including any changes made to that Article and its Commentaries.

* E/C.18/2010/1.

** The views and opinions expressed in the present note are those of the working group on definition of permanent establishment (Coordinator: Peter van der Merwe) and do not necessarily represent those of the United Nations.

[1] See *Official Records of the Economic and Social Council, 2009, Supplement No. 25* (E/2009/45), paras. 9 and 10.

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II. Proposed commentary

3. In order to ensure that its work could be made as widely available as possible for the United Nations Committee of Experts on International Cooperation in Tax Matters at its sixth session, the Working Group has addressed proposed paragraphs 1 to 15.13 of the Commentary on Article 5 of the United Nations Model Double Taxation Convention between Developed and Developing Countries[2] in the present note (see annex). Paragraphs 15.14 to 37 are considered in the companion note (E/C.18/2010/6), and the two papers should be considered together.

4. The proposed Commentary reflects the new Commentary agreed by the Committee at its 2007 annual session,[3] with proposed changes to deal with the amendments to the text of Article 5 agreed at the 2009 annual session and reflected in the report of that session.[4] In accordance with the Working Group's mandate, however, the proposed Commentary also addresses the option of removal of Article 14, should negotiating countries agree to do so in a bilateral treaty. This reflects the decision taken by the Committee at its fifth annual session in 2009.[5]

5. Any substantive proposed changes to the content of the annex to conference room paper E/C.18/2008/CRP.10 are presented in bold for emphasis, as this note does not seek to reopen the text previously agreed by the Committee, except as required by its mandate.

[2] United Nations publication, Sales No. E.01.XVI.2.

[3] See E/C.18/2008/CRP.10.

[4] See *Official Records of the Economic and Social Council, 2009, Supplement No. 25* (E/2009/45), paras. 17-19.

[5] Ibid., para. 18.

Annex

Proposed amended Commentary on Article 5 of the United Nations Model (Paras. 1 to 15.13)

ARTICLE 5

PERMANENT ESTABLISHMENT

A. GENERAL CONSIDERATIONS

1. Article 5 of the United Nations Model Double Taxation Convention between Developed and Developing Countries (hereinafter referred to as the "UN Model") is based on Article 5 of the OECD Model Tax Convention (hereinafter referred to as the "OECD Model") but contains several significant differences. In essence these are that under the UN Model:

- there is a six-month test for a building or construction site constituting a permanent establishment, rather than the 12-month test under the OECD Model, and it expressly extends to assembly projects, as well as supervisory activities in connection with building sites and construction, assembly or installation projects (para. 3 of the UN Model Article);

- the furnishing of services by an enterprise through employees or other personnel results in a permanent establishment where such activities continue for a total of ~~**6 months in a twelve month period**~~ **more than 183 days in any 12-month period commencing or ending in the fiscal year concerned** (para. 3(b));

- **Article 14 (Independent Personal Services) has been retained, whereas in the OECD Model, Article 14 has been deleted, and Article 5 addresses cases that were previously considered under the "fixed base" test of that Article. As noted below (in para. 15.1 and thereafter), while the UN Model has retained Article 14, the present Commentary provides guidance for those countries not wishing to have such an article in their bilateral tax agreements;**

- in the paragraph 4 list of what is deemed *not* to constitute a permanent establishment (often referred to as the list of "preparatory and auxiliary activities") "delivery" is not mentioned in the UN Model, but is mentioned in the OECD Model. Therefore a delivery activity might result in a permanent establishment under the UN Model, without doing so under the OECD Model;

- the actions of a "dependent agent" may constitute a permanent establishment, even without having and habitually exercising the authority to conclude contracts in the name of the enterprise, where that person habitually maintains a stock of goods or merchandise and regularly makes deliveries from the stock (para. 5 (b));

- there is a special provision specifying when a permanent establishment is created in the case of an insurance business; consequently a permanent establishment is more likely to exist under the UN Model approach (para. 6); and

while an independent agent acting as such will usually not create a permanent establishment for the enterprise making use of the agent because such an agent is effectively operating his own business providing a service. **As with the OECD Model**, the UN Model indicates that such an agent devoting all or nearly all their time to a particular client and not dealing with the client at an arm's length basis is not treated as having the necessary independence (para. 7).

These differences are considered in more detail below.

2. The concept of "permanent establishment" is used in bilateral tax treaties to determine the right of a State to tax the profits of an enterprise of the other State. Specifically, the profits of an enterprise of one State are taxable in the other State only if the enterprise maintains a permanent establishment in the latter State and only to the extent that the profits are attributable to the permanent establishment. The concept of permanent establishment is found in the early model conventions including the 1928 model conventions of the League of Nations. The UN Model reaffirms the concept.

E. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 5

Paragraph 1

3. This paragraph, which reproduces Article 5 (1) of the OECD Model, defines the term "permanent establishment", emphasizing its essential nature as a "fixed place of business" with a specific "situs". According to paragraph 2 of the OECD Commentary (the 2008 version of which is cited below), this definition contains the following conditions:

- the existence of a "place of business", i.e., a facility such as premises or, in certain instances, machinery or equipment;
- this place of business must be "fixed", i.e., it must be established at a distinct place with a certain degree of permanence;
- the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

The OECD Commentary goes on to observe:

> *3.* It could perhaps be argued that in the general definition some mention should also be made of the other characteristic of a permanent establishment to which some importance has sometimes been attached in the past, namely that the establishment must have a productive character, i.e. contribute to the profits of the enterprise. In the present definition this course has not been taken. Within the framework of a well-run business organisation it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organisation a particular establishment has "a productive character" it is consequently a permanent establishment to which profits can properly be attributed for the purpose of tax in a particular territory (cf. Commentary on paragraph 4).

4 The term "place of business" covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (e.g., for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the case, for instance, where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.

4.1 As noted above, the mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is therefore required. Thus, for instance, a permanent establishment could exist where an enterprise illegally occupied a certain location where it carried on its business.

4.2 Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise. These principles are illustrated by the following examples where representatives of one enterprise are present on the premises of another enterprise. A first example is that of a salesman who regularly visits a major customer to take orders and meets the purchasing director in his office to do so. In that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a fixed place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist).

4.3 A second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e.g., a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a "fixed place of business" (see paragraphs 6 to 6.3) and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article.

4.4 A third example is that of a road transportation enterprise which would use a delivery dock at a customer's warehouse every day for a number of years for the purpose of delivering goods purchased by that customer. In that case, the presence of the road transportation enterprise at the delivery dock would be so limited that that enterprise could not consider that place as being at its disposal so as to constitute a permanent establishment of that enterprise.

4.5 A fourth example is that of a painter who, for two years, spends three days a week in the large office building of its main client. In that case, the presence of the painter in that office building where he is performing the most important functions of his business (i.e. painting) constitute a permanent establishment of that painter.

4.6 The words "through which" must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business "through" the location where this activity takes place.

5. According to the definition, the place of business has to be a "fixed" one. Thus in the normal way there has to be a link between the place of business and a specific geographical point. It is immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site (but cf. paragraph 20 below).

5.1 Where the nature of the business activities carried on by an enterprise is such that these activities are often moved between neighbouring locations, there may be difficulties in determining whether there is a single "place of business" (if two places of business are occupied and the other requirements of Article 5 are met, the enterprise will, of course, have two permanent establishments). As recognised in paragraphs 18 and 20 below a single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to that business.

5.2 This principle may be illustrated by examples. A mine clearly constitutes a single place of business even though business activities may move from one location to another in what may be a very large mine as it constitutes a single geographical and commercial unit as concerns the mining business. Similarly, an "office hotel" in which a consulting firm regularly rents different offices may be considered to be a single place of business of that firm since, in that case, the building constitutes a whole geographically and the hotel is a single place of business for the consulting firm. For the same reason, a pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand represents a single place of business for that trader.

The OECD Commentary then examines some examples relating to the provision of services. In quoting the following two paragraphs, the Committee notes that Article 5 (3) (b) of the UN Model provides a specific provision in relation to furnishing of services by an enterprise through employees or personnel engaged for that purpose. In practice, therefore, the points made in paragraphs 5.3 and 5.4 of the OECD Model Commentary (as with other parts of the OECD Commentary to Article 5 (1)) may have less significance for the UN Model than in their original context.

5.3 By contrast, where there is no commercial coherence, the fact that activities may be carried on within a limited geographic area should not result

in that area being considered as a single place of business. For example, where a painter works successively under a series of unrelated contracts for a number of unrelated clients in a large office building so that it cannot be said that there is one single project for repainting the building, the building should not be regarded as a single place of business for the purpose of that work. However, in the different example of a painter who, under a single contract, undertakes work throughout a building for a single client, this constitutes a single project for that painter and the building as a whole can then be regarded as a single place of business for the purpose of that work as it would then constitute a coherent whole commercially and geographically.

5.4 Conversely, an area where activities are carried on as part of a single project which constitutes a coherent commercial whole may lack the necessary geographic coherence to be considered as a single place of business. For example, where a consultant works at different branches in separate locations pursuant to a single project for training the employees of a bank, each branch should be considered separately. However, if the consultant moves from one office to another within the same branch location, he should be considered to remain in the same place of business. The single branch location possesses geographical coherence which is absent where the consultant moves between branches in different locations.

The OECD Commentary then continues:

6. Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices followed by Member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months). One exception has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years). Another exception has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried on in that country, its connection with that country is stronger. For ease of administration, countries may want to consider these practices when they address disagreements as to whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.

The Committee agreed with the approach taken in paragraph 6 of the OECD Commentary, while recognizing that such situations will not often arise in practice,

and that special care should therefore be taken when relying on paragraph 6 as applicable in an actual case. The OECD Commentary continues:

> *6.1* As mentioned in paragraphs 11 and 19, temporary interruptions of activities do not cause a permanent establishment to cease to exist. Similarly, as discussed in paragraph 6, where a particular place of business is used for only very short periods of time but such usage takes place regularly over long periods of time, the place of business should not be considered to be of a purely temporary nature.
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> *6.2* Also, there may be cases where a particular place of business would be used for very short periods of time by a number of similar businesses carried on by the same or related persons in an attempt to avoid that the place be considered to have been used for more than purely temporary purposes by each particular business. The remarks of paragraph 18 on arrangements intended to abuse the 12-month period provided for in paragraph 3 would equally apply to such cases.
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> *6.3* Where a place of business which was, at the outset, designed to be used for such a short period of time that it would not have constituted a permanent establishment but is in fact maintained for such a period that it can no longer be considered as a temporary one, it becomes a fixed place of business and thus — retrospectively — a permanent establishment. A place of business can also constitute a permanent establishment from its inception even though it existed, in practice, for a very short period of time, if as a consequence of special circumstances (e.g. death of the taxpayer, investment failure), it was prematurely liquidated.
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> *7.* For a place of business to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it. As stated in paragraph 3 above, the activity need not be of a productive character. Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.
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> *8.* Where tangible property such as facilities, industrial, commercial or scientific (ICS) equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. If an enterprise of a State lets or leases facilities, ICS equipment, buildings or intangible property to an enterprise of the other State without maintaining for such letting or leasing activity a fixed place of business in the other State, the leased facility, ICS equipment, building or intangible property, as such, will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the ICS equipment etc. This remains the case even when, for example, the lessor supplies personnel after installation to operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the ICS equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibilities, for example participation in the decisions regarding the work for which the equipment is used, or if they operate, service, inspect and maintain the equipment under the responsibility

and control of the lessor, the activity of the lessor may go beyond the mere leasing of ICS equipment and may constitute an entrepreneurial activity. In such a case a permanent establishment could be deemed to exist if the criterion of permanency is met. When such activity is connected with, or is similar in character to, those mentioned in paragraph 3, the time limit of [six] months applies. Other cases have to be determined according to the circumstances.

10. The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g., dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorised to conclude contracts if he works at the fixed place of business. But a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.

11. A permanent establishment begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares, at the place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that this activity differs substantially from the activity for which the place of business is to serve permanently. The permanent establishment ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it, that is when all acts and measures connected with the former activities of the permanent establishment are terminated (winding up current business transactions, maintenance and repair of facilities). A temporary interruption of operations, however, cannot be regarded as closure. If the fixed place of business is leased to another enterprise, it will normally only serve the activities of that enterprise instead of the lessor's; in general, the lessor's permanent establishment ceases to exist, except where he continues carrying on a business activity of his own through the fixed place of business.

Paragraph 2

4. Paragraph 2, which reproduces Article 5 (2) of the OECD Model, lists examples of places that will often constitute a permanent establishment. However, the provision is not self-standing. While paragraph 2 notes that offices, factories, etc., are common types of permanent establishments, when one is looking at the operations of a particular enterprise, the requirements of paragraph 1 must also be

met. Paragraph 2 therefore simply provides an indication that a permanent establishment may well exist; it does not prove that one necessarily does exist. This is also the stance of the OECD Commentary, where it is assumed that States interpret the terms listed "in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1". Developing countries often wish to broaden the scope of the term "permanent establishment" and some believe that a warehouse should be included among the specific examples. However, the deletion of "delivery" from the excluded activities described in paragraph 4 (a) and (b) means that a "warehouse" used for any purpose is (subject to the conditions in paragraph 1 being fulfilled) a permanent establishment under the general principles of the Article. The OECD Commentary points out in paragraph 13 that the term "place of management" is mentioned separately because it is not necessarily an "office" and that "where the laws of the two Contracting States do not contain the concept of a 'place of management' as distinct from an 'office', there will be no need to refer to the former term in their bilateral convention".

5. In discussing subparagraph (f), which provides that the term "permanent establishment" includes mines, oil or gas wells, quarries or any other place of extraction of natural resources, the OECD Commentary states that "the term 'any other place of extraction of natural resources' should be interpreted broadly" to include, for example, all places of extraction of hydrocarbons whether on or offshore. Because subparagraph (f) does not mention exploration for natural resources, whether on or offshore, paragraph 1 governs whether exploration activities are carried on through a permanent establishment. The OECD Commentary states:

> *15.* Since, however, it has not been possible to arrive at a common view on the basic questions of the attribution of taxation rights and of the qualification of the income from exploration activities, the Contracting States may agree upon the insertion of specific provisions. They may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State:
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> (a) shall be deemed not to have a permanent establishment in that other State; or
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> (b) shall be deemed to carry on such activities through a permanent establishment in that other State; or
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> (c) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period of time.
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> The Contracting States may moreover agree to submit the income from such activities to any other rule.

6. As mentioned above, in subparagraph (f) the expression "any other place of extraction of natural resources" should be interpreted broadly. Some have argued that, for this purpose, a fishing vessel could be treated as a place of extraction or exploitation of natural resources since "fish" constitute a natural resource. In their analysis, although it is true that all places or apparatus designated as "permanent establishments" in subparagraphs (a) to (e) in paragraph 2 have a certain degree of permanence or constitute "immovable property", fishing vessels can be considered

as a place used for extraction of natural resources, which may not necessarily mean only minerals embedded in the Earth. In this view, fishing vessels can be compared to the movable drilling platform that is used in off-shore drilling operations for gaining access to oil or gas. Where such fishing vessels are used in the territorial waters or the exclusive economic zone of the coastal State, their activities would constitute a permanent establishment, situated in that State. However, others are of the view that such an interpretation was open to objection in that it constituted too broad a reading of the term "permanent establishment" and of the natural language of the subparagraph. Accordingly, in their opinion, any treaty partner countries which sought to advance such a proposition in respect of fishing activities, should make that explicit by adopting it as a new and separate category in the list contained in this Article. Consequently, the interpretation on the nature of this activity has been left to negotiations between Contracting States so that, for example, countries which believe that a fishing vessel can be a permanent establishment might choose to make that explicit in this Article, such as by the approach outlined in paragraph 13 of this Commentary. The interpretation as to the nature of this activity would, therefore, be left to negotiations between Contracting States.

Paragraph 3

7. This paragraph covers a broader range of activities than Article 5 (3) of the OECD Model, which states, "A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months". In addition to the term "installation project" used in the OECD Model, subparagraph 3 (a) of the UN Model includes an "assembly project" as well as "supervisory activities" in connection with "a building site, a construction, assembly or installation project". Another difference is that while the OECD Model uses a time limit of 12 months, the UN Model reduces the minimum duration to six months. In special cases, this six-month period could be reduced in bilateral negotiations to not less than three months. The Committee notes that there are differing views about whether paragraph 3 (a) is a "self-standing" provision (so that no resort to paragraph 1 is required) or whether (in contrast) only building sites and the like that meet the criteria of paragraph 1 would constitute permanent establishments, subject to there being a specific six-month test. However, the Committee considers that where a building site exists for six months, it will in practice almost invariably also meet the requirements of paragraph 1. In fact, an enterprise having a building site, etc., at its disposal, through which its activities are wholly or partly carried on will also meet the criteria of paragraph 1.

8. Some countries support a more elaborate version of paragraph 3 (a), which would extend the provision to encompass a situation "where such project or activity, being incidental to the sale of machinery or equipment, continues for a period not exceeding six months and the charges payable for the project or activities exceed 10 per cent of the sale price of the machinery or equipment". Other countries believe that such a provision would not be appropriate, particularly if the machinery were installed by an enterprise other than the one doing the construction work.

9. Article 5 (3) (b) deals with the furnishing of services, including consultancy services, the performance of which does not, of itself, create a permanent establishment in the OECD Model. Many developing countries believe that management and consultancy services should be covered because the provision of those services in developing countries by enterprises of industrialized countries can

generate large profits. **In the (2011) version of the UN Model, the Committee agreed to a slight change in the wording of subparagraph 3 (b), which was amended to read: "but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned", rather than, "but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any 12-month period", as it formerly read. This was seen as providing greater consistency with the approach taken in Article 14 (1) (b).**

10. A few developing countries oppose the six-month **(or 183 days)** thresholds in paragraph 3 (a) and (b) altogether. They have two main reasons: first, they maintain that construction, assembly and similar activities could, as a result of modern technology, be of very short duration and still result in a substantial profit for the enterprise; second, and more fundamentally, they simply believe that the period during which foreign personnel remain in the source country is irrelevant to their right to tax the income (as it is in the case of artistes and sportspersons under Article 17). Other developing countries oppose a time limit because it could be used by foreign enterprises to set up artificial arrangements to avoid taxation in their territory. However, the purpose of bilateral treaties is to promote international trade, investment, and development, and the reason for the time limit (indeed for the permanent establishment threshold more generally) is to encourage businesses to undertake preparatory or ancillary operations in another State that will facilitate a more permanent and substantial commitment later on, without becoming immediately subject to tax in that State.

11. In this connection, the OECD Commentary observes, with changes in parentheses to take account of the different time periods in the two Models:

> *18.* The [six]-month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g., for a row of houses). The [six]-month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than [six] months and attributed to a different company, which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations.

The Committee points out that measures to counteract abuses would apply equally in cases under Article 5 (3) (b). The Commentary of the OECD Model continues as follows:

> *19.* A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established, e.g., if he installs a planning office for the construction. In general, it continues to exist until the work is completed or permanently abandoned. A site should not be regarded as ceasing to exist when work is temporarily discontinued. Seasonal or other temporary interruptions should be included in determining the life of a site. Seasonal interruptions include interruptions due to bad weather. Temporary interruption could be caused, for example, by shortage of material or labour difficulties. Thus, for example, if a contractor started work on a road on 1st May, stopped on 1st [August] because of bad weather conditions or a lack of materials but resumed work on 1st [October], completing the road on 1st [January] the following year, his construction project should be regarded as a permanent establishment because [eight] months elapsed between the date he commenced work (1st May) and the date he finally finished (1st [January] of the following year). If an enterprise (general contractor) which has undertaken the performance of a comprehensive project, subcontracts parts of such a project to other enterprises (subcontractors), the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project. The subcontractor himself has a permanent establishment at the site if his activities there last more than [six] months.

The Committee considers that the reference in the penultimate sentence of this paragraph of the OECD Commentary to "parts" of such a project should not be taken to imply that an enterprise subcontracting *all* parts of the project could never have a permanent establishment in the host State.

The Commentary of the OECD Model continues as follows:

> *19.1* In the case of fiscally transparent partnerships, the [six]-month test is applied at the level of the partnership as concerns its own activities. If the period of time spent on the site by the partners and the employees of the partnership exceeds [six] months, the enterprise carried on by the partnership will therefore be considered to have a permanent establishment. Each partner will thus be considered to have a permanent establishment for purposes of the taxation of his share of the business profits derived by the partnership regardless of the time spent by himself on the site.
>
> *20.* The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipelines laid. Similarly, where parts of a substantial structure such as an offshore platform are assembled at various locations within a country and moved to another location within the country for final assembly, this is part of a single project. In such a case, the fact that the work force is not present for [six] months in one particular place is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts for more than [six] months.

12. Subparagraph (b) encompasses service activities only if they "continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than **183 days in any 12-month period commencing or ending**

in the fiscal year concerned ~~**six months within any 12-month period**~~". The words "for the same or a connected project" are included because it is not appropriate to add together unrelated projects in view of the uncertainty which that step involves and the undesirable distinction it creates between an enterprise with, for example, one project of ~~**three months'**~~ **95 days'** duration and another enterprise with two unrelated projects, each of ~~**three months'**~~ **95 days'** duration, one following the other. However, some countries find the "project" limitation either too easy to manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of ~~**four or five months'**~~ **120 or 150 days'** duration.

13. If States wish to treat fishing vessels in their territorial waters as constituting a permanent establishment (see para. 6 above), they could add a suitable provision to paragraph 3, which, for example, might apply only to catches over a specified level, or by reference to some other criterion.

14. If a permanent establishment is deemed to exist under paragraph 3, only profits attributable to the activities carried on through that permanent establishment are taxable in the source country.

15. The following passages of the Commentary on the OECD Model are relevant to Article 5 (3) (a) of the UN Model, although the reference to an "assembly project" in the UN Model and not in the OECD Model, and the six-month period in the UN Model should, in particular, be borne in mind:

> *16.* This paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than 12 months. Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity. Where, however, such an office or workshop is used for a number of construction projects and the activities performed therein go beyond those mentioned in paragraph 4, it will be considered a permanent establishment if the conditions of the Article are otherwise met even if none of the projects involve a building site or construction or installation project that lasts more than 12 months. In that case, the situation of the workshop or office will therefore be different from that of these sites or projects, none of which will constitute a permanent establishment, and it will be important to ensure that only the profits properly attributable to the functions performed and risks assumed through that office or workshop are attributed to the permanent establishment. This could include profits attributable to functions performed and risks assumed in relation to the various construction sites but only to the extent that these functions and risks are properly attributable to the office.
>
> *17.* The term "building site or construction or installation project" includes not only the construction of buildings but also the construction of roads, bridges or canals, the renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals, the laying of pipelines and excavating and dredging. Additionally, the term "installation project" is not restricted to an installation related to a construction project; it also includes the installation of new equipment, such as a complex machine, in an existing building or outdoors. On-site planning and supervision of the erection of a

building are covered by paragraph 3. States wishing to modify the text of the paragraph to provide expressly for that result are free to do so in their bilateral conventions.

Alternative text for countries wishing to delete Article 14

15.1. **Some countries have taken the view that Article 14 should be deleted and its coverage introduced into Articles 5 and 7. Countries taking such a view often do so because they perceive that the "fixed base" concept in Article 14 has widely acknowledged uncertainties and that the "permanent establishment" concept can accommodate the taxing rights covered by Article 14. This approach is expressed by the Commentary on Article 5 of the OECD Model as follows:**

> *1.1* **Before 2000, income from professional services and other activities of an independent character was dealt with under a separate Article, i.e., Article 14. The provisions of that Article were similar to those applicable to business profits but it used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The elimination of Article 14 therefore meant that the definition of permanent establishment became applicable to what previously constituted a fixed base.**

15.2 **Many countries do not hold to these views, do not believe they are sufficient to warrant deletion of Article 14, or consider that differences in meaning exist between the "fixed base" (Article 14) and "permanent establishment" (Article 5) concepts, and that because of these differences, the removal of Article 14 and reliance on Articles 5 and 7 will, or at least may, in practice lead to a reduction of source State taxing rights. Considering the differences of views in this area, differences which could not be bridged by a single provision, the Committee decided that Article 14 would be retained in the UN Model but that guidance in the form of an alternative provision would be provided in this Commentary for countries wishing to delete Article 14 and address situations currently covered by it under Articles 5 and 7.**

15.3 **This alternative differs from that provided for under the OECD Model, which reflected in its changes the conclusions of a report on Article 14 released in a 2000 OECD report.[6] That report suggested certain changes to Articles of the OECD Model (and bilateral treaties) as well as consequential changes to the Commentaries. Since most countries deleting Article 14 will be doing so for the reasons outlined in the OECD report, and are likely to follow the recommendations in the OECD Model, the changes to the Articles proposed in that report, as they now appear in the OECD Model, are addressed in the paragraphs below regarding the possible deletion of Article 14. The differences**

[6] Organization for Economic Cooperation and Development, *Issues in International Taxation Issues Related to Article 14 of the OECD Model Tax Convention: No. 7* (Organization for Economic Cooperation and Development, 2000).

between that approach and the alternative wording provided below, result from relevant differences between Article 14 of the UN Model and Article 14 as it previously appeared in the OECD Model.

15.4 Since the deletion of Article 14 is merely presented as an option that some countries may prefer to follow, the entire discussion on the consequential implications of such an approach is addressed in this Commentary on Article 5, including identifying the possibility, and in most cases the need, to make certain consequential changes reflecting the deletion of Article 14, the need to remove references to "independent personal services" and "fixed base" and the possibility of removing references to "dependent personal services" for the sake of clarity.

Changes to Articles 14 and 5

15.5 Article 14 would be deleted. Subparagraph (b) of Article 5 (3) would read as follows:

> "(b) the furnishing of services by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or connected project) within a Contracting State for a period or periods aggregating more than 183 days within any twelve-month period commencing or ending in the fiscal year concerned;"

15.6 The changes to the version of this subparagraph in the 2001 UN Model are minor, comprising (i) the deletion of the words "including consultancy services", after the words "the furnishing of services", on the basis that the wording was unnecessary and confusing, such services being clearly covered; (ii) the replacement of the six-month test with the 183 days test, as noted in paragraph 9 above; and (iii) the use of a semicolon rather than a period at the end of the subparagraph, with the introduction of subparagraph (c).

15.7 A new subparagraph 3 (c) would also be inserted, as follows:

> "(c) for an individual, the performing of services in a Contracting State by that individual, but only if the individual's stay in that State is for a period or periods aggregating more than 183 days within any 12-month period commencing or ending in the fiscal year concerned."

15.8 Subparagraph (c) is intended to ensure that any situation previously covered by Article 14 would now be addressed by Articles 5 and 7. The wording reflects the fact that deletion of Article 14 of the UN Model would involve deletion of the "days of physical presence" test found in subparagraph 1 (b) of Article 14 of that Model, which had no counterpart in the OECD Model when the deletion of Article 14 was agreed for that Model.

15.9 It should be noted that subparagraph (c), in attempting to reflect operation of the current Article 14 (1) (b), more explicitly indicates that the subparagraph only applies to individuals. In this respect, it follows and makes clearer the interpretation found in paragraph 9 of the Commentary on Article 14, to the effect that Article 14 deals only with individuals. The Committee notes that some countries do not accept that view and should seek to clarify the issue when negotiating Article 14.

15.10 It should also be noted that the last part of Article 14 (1) (b) has not been transposed into Article 5: ("... in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State"). The reason for this is that Article 7 provides its own attribution rules, which, in most cases, means that only the profits of an enterprise attributable to that permanent establishment (that is, the "physical presence" in subparagraph 3 (c)) may be taxed by the State where the permanent establishment exists. In the relatively small number of cases where a "limited force of attraction" rule as provided for in Article 7 has been adopted in bilateral treaties, other business activities of a same or similar kind as those effected through the physical presence permanent establishment may be taxed by the State where the permanent establishment exists, which can be justified as treating various forms of permanent establishment in the same way. In the event, likely to be very rare in practice, of States agreeing to a limited force of attraction rule in Article 7 and also to deletion of Article 14, but not wishing to apply the limited force of attraction rule to cases formerly dealt with by Article 14 (1) (b), it could explicitly be provided that such a rule did not apply to subparagraph (3) (c) cases.

Consequential changes to other Articles

5.11 In paragraph 1 of Article 3, existing subparagraphs (c) to (f) should be renumbered as subparagraphs (d) to (g) and the following new subparagraphs (c) and (h) added:

> *"(c) the* term *"enterprise" applies to the carrying on of any business;*
>
> *"(h) the* term *"business" includes the performance of professional services and of other activities of an independent character."*

15.12 The reasoning for this change is reflected in paragraphs 4 and 10.2 of the OECD Commentary on Article 3 as follows:

> *4.* The question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States. No exhaustive definition of the term "enterprise" has therefore been attempted in this Article. However, it is provided that the term "enterprise" applies to the carrying on of any business. Since the term "business" is expressly defined to include the performance of professional services and of other activities of an independent character, this clarifies that the performance of professional services or other activities of an independent character must be considered to constitute an enterprise, regardless of the meaning of that term under domestic law. States which consider that such clarification is unnecessary are free to omit the definition of the term "enterprise" from their bilateral conventions.
>
> *10.2* The Convention does not contain an exhaustive definition of the term "business", which, under paragraph 2, should generally have the meaning which it has under the domestic law of the State that applies to the Convention. [S]ubparagraph (*h*), however, provides expressly that the term includes the performance of professional services and of other

activities of an independent character. This provision was added in 2000 at the same time that Article 14, which dealt with Independent Personal Services, was deleted from the Convention. This addition, which ensures that the term "business" includes the performance of the activities that were previously covered by Article 14, was intended to prevent that the term "business" be interpreted in a restricted way so as to exclude the performance of professional services, or other activities of an independent character, in States where the domestic law does not consider that the performance of such services or activities can constitute a business. Contracting States for which this is not the case are free to agree bilaterally to omit the definition.

15.13 Paragraph 4 of Article 6 should be amended by removing the reference to independent personal services as follows:

"*4.* The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise ~~and to income from immovable property used for the performance of independent personal services~~."